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FATCA Law Tightens Net On Undisclosed Foreign Assets

Law360, New York (December 19, 2012, 1:16 PM ET) -- Benjamin Franklin quipped that "in this world nothing can be said to be certain, except death and taxes." While taxes are not overtaking death in certainty, with the 2013 implementation of the Foreign Account Tax Compliance Act just around the corner, taxes are holding their own. In a nutshell, FATCA will mean that any financial institution that wants to do business with the U.S. must either (1) assist the IRS in identifying U.S. tax evaders with overseas assets, (2) pay a modest — ahem — 30-percent fee on all U.S. transactions, or (3) lie and risk being criminally prosecuted. Nothing like stark choices to focus the mind.

By the time the full FATCA penalties take effect in 2017, foreign financial institutions ("FFIs") will be faced with the trilemma of either dropping their U.S. customers, paying the draconian FATCA penalty, or, more likely, cozying up to the IRS' new enforcement regime. Some foreign banks have called it quits on their U.S. customers already, yielding before the bureaucratic juggernaut that is FATCA.[1]

Others, including the governments of one-time tax havens like Bermuda and the British Virgin Islands, soldier on through endless negotiations with the U.S. Department of the Treasury, hoping to escape the full weight of FATCA compliance or at least delay it.[2] As these and other jurisdictions are quickly discovering, there's a big difference between paying lip service to U.S. tax evasion laws and putting a 30-percent penalty where your mouth is. Things are about to get a lot hotter for holders of undisclosed offshore accounts.

FATCA was born in controversy in 2010 as part of the Hiring incentives to Restore Employment (HIRE) Act, almost immediately sparking privacy concerns and fears about the costs of compliance. In 2011, The Economist magazine slammed FATCA for creating a "bureaucratic nightmare around the world" forcing fund managers to take "drastic measures" that might lead to "some global funds avoiding American assets entirely."[3] Beyond the new reporting requirements for U.S. taxpayers holding foreign financial assets,[4] the key provision of FATCA that has The Economist reaching for its pitchfork is the disclosure obligation for foreign financial institutions.

Under FATCA, FFIs will be required to provide information about financial accounts held by U.S. taxpayers or foreign entities owned, or partially owned, by U.S. taxpayers directly to the IRS. FATCA will require FFIs to (1) identify and conduct due diligence with regard to U.S. account-holders, (2) submit an annual report to the IRS on all U.S. account-holders, including U.S.-owned entities who hold foreign accounts, and (3) withhold and pay to the IRS 30 percent of any transaction with a nonparticipating FFI or an account-holder who fails to provide the required information.

FATCA envisions a phased rollout of these provisions, with registration for the appropriately named "special agreement" with the IRS beginning Jan. 1, 2013, all participating FFIs for fiscal year 2014 registered with the IRS by June 30, 2013, and the 30-percent transaction penalty beginning Jan. 1, 2017. Given the heft of the transaction penalty, and the breadth of transactions it is applicable to,[5] it is expected that by the 2017 deadline FFIs will either have dropped their U.S. customers or will be carefully preparing their diligence files for submission to the IRS: Either way, bad news for the holders of unreported overseas accounts or assets.

And as if the FATCA alone were not enough, this year the Treasury Department has announced sweeping negotiations with over 50 countries to enter into FATCA-enabling intergovernmental agreements.[6] U.S. allies and major economic players like the United Kingdom, France, Germany, Japan, Italy and Canada, among others, have either signed bilateral agreements to assist with FATCA or are expected to do so in the near future. Close behind these is a second tranche of rising economies with whom the Treasury is "actively engaged in a dialogue" to implement and support FATCA provisions.

Notably, this second group includes several jurisdictions traditionally regarded as U.S. tax havens, including: Liechtenstein, the Cayman Islands, Luxembourg, the British Virgin Islands, Gibraltar, Guernsey, and the Island of Man, to name a few. Willing or not, as more of these havens fall in line behind the new FATCA regime, the days of U.S. capital lazily sunning itself on Caribbean islands and wintering in obscure, European city-states may be coming to end. Or at least moving elsewhere, to less FATCA compliant jurisdictions and smaller FFIs that don't conduct much U.S. business. Call them "Tax Havens: The Next Generation."

But it remains to been seen whether by 2017 there will be anywhere left for the U.S. tax evader to escape the long reach of FATCA. Long European tradition of bank secrecy laws, you say? FFIs with no interest in the U.S., you say? Perhaps. But our bet is that, over the next several years, holders of undisclosed foreign assets will learn, to their displeasure, that as much as foreign tax havens value their banking secrecy, they value doing business with the U.S. more. After all, no tax haven is an island.[7] Barring a repeal or major overhaul of FATCA regulations, the world is going to get a lot smaller and a lot more open on Jan. 1, 2017.

So what's the honest evader to do? Simple. Get right with the IRS now, before FATCA regulations force your FFI to get right with the IRS for you. As you may have guessed, the IRS is less than keen on undisclosed foreign assets. Discovery of undisclosed offshore earnings or assets can generate civil fines, back taxes, interest and penalties that greatly exceed the amount of any undisclosed assets. Call it the 400-percent tax bracket. Of course, unreported foreign assets also can net the taxpayer a long-term stay in federal prison. But never let it be said that the IRS is without mercy. Even as the FATCA deadline looms, the IRS has extended a lifeline for the penitent tax evader: the 2012 Offshore Voluntary Disclosure Program.

As the name would suggest, the 2012 OVDP is the successor to the 2011 and 2009 programs of the same name, with two important differences. First, unlike the previous programs there's no set deadline for participation; it remains open to U.S. taxpayers with unreported assets provided the IRS hasn't already begun a criminal investigation. Second, the 2012 OVDP comes with higher penalties than the predecessor programs, but what did you expect from the IRS? Successful completion of the disclosure program allows the taxpayer to avoid criminal prosecution, repatriate funds that may have been "stuck" overseas, and cut their fines and penalties substantially, though penalties still are likely to amount to a substantial portion of the unreported assets. A tough bargain to be sure, but not as tough as the one you'll find yourself in should the IRS come knocking on your door with a copy of the a FFI disclosure in its hand. But latecomers to the OVDP program beware, there's no guarantee that the program will stay open or that the terms won't change for the worse.

As unpalatable as full disclosure to the IRS sounds, with the FATCA noose tightening around offshore financial institutions, the fact is that once “safe” tax havens are going to become increasingly unsafe. And the key to avoiding astronomical tax penalties and jail time for tax evasion is to come to the IRS, hat in hand, before the IRS comes to you. Bottom line: If you’ve got money squirreled away in some duchy or principality or island stronghold that you haven’t told the IRS about, now’s the time to get right with Uncle Sam … before FATCA kicks in and your little secret shows up as a line item on some FFI’s disclosure form.

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[1] Der Spiegel Online, European Banks Stop Serving American Customers, December, 2011, available online at: http://www.spiegel.de/international/business/reaction-to-us-tax-law-european-banks-stop-serving-american-customers-a-803742.html (last visited Dec. 14, 2012); The Local, Germany Edition, German Banks Abandon US Customers, December, 2011, available online at: http://www.thelocal.de/money/20111215-39519.html (last visited Dec. 14, 2012).

[2] U.S. Dep’t. of the Treasury, press release, U.S. Engaging with More than 50 Jurisdictions to Curtail Offshore Tax Evasion, Nov. 8, 2012.

[3] The Economist, Scratched By the FATCA, Nov. 26, 2011, available online at: http://www.economist.com/node/21540270 (last visited Dec. 14, 2012).

[4] 26 U.S.C. 6038(a)(1).

[5] Proposed regulations apply the transaction tax to “any payments of U.S. source income, as well as gross proceeds from the sale of securities that generate U.S. source income.” Internal Revenue Service website, Summary of Key FATCA Provisions, available online at: http://www.irs.gov/Businesses/Corporations/Summary-of-Key-FATCA-Provisions (last visited Dec. 14, 2012).

[6] See note 2, supra.

[7] Note: Many tax havens are, in fact, islands.